

REDUCTION OF TAX EXEMPTIONS BY REASON OF RECEIPT OF TAX-EXEMPT INCOME

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The problem discussed in this article may best be understood by outlining an illustrative hypothetical case, as follows:

A, a resident of the state of *X*, is an employee of the federal government, from which he receives an annual salary of \$3000. He also receives an equal amount from personal investments, so that his total annual income is \$6000.

The state of *X* imposes an income tax, but allows a personal exemption of \$3000. It is provided, of course, that income from the federal government (including interest on its securities) is exempt from taxation, but it is also provided that the personal exemption is to be reduced to the extent of all such non-taxable income received by the taxpayer. The result is that *A* receives no personal exemption, and is obliged to pay a tax on the basis of \$3000. He thus obtains no benefit by reason of the fact that part of his income is derived from the federal government and is not taxable by *X*; and he pays the same tax as his neighbor, *B*, who has a \$6000 income no part of which is derived from the federal government or its agencies. On the other hand, the federal income is itself not directly taxed.

The problem presented is whether this provision of the state tax law, reducing the personal exemption by reason of the receipt of income itself non-taxable because derived from the federal government, is unconstitutional because imposing an indirect burden upon the federal functions. In other words, the question comes down to whether it is sufficient for the states to refrain from discriminating against a taxpayer who receives income from the federal government or whether he must be treated better than others who do not receive such income.

Of course, the same question will arise if deductions for computing taxable income rather than personal exemptions are reduced by the receipt of non-taxable income, since the result is the same. Also the question may arise where the federal tax laws provide for the reduction of statutory personal exemptions or deductions by the amount of income received from the states and therefore non-taxable by the United States. If the hypothetical case stated at the beginning involves an unconstitutional burden upon the federal government by the state, the present assumed situation is likewise an

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improper burden on the states by the United States. And the problem is likewise presented by state property taxes which without directly taxing United States securities, yet by reducing deductions or exemptions seek to remove or reduce the benefit to the taxpayer of the non-taxability of these bonds.

Almost precisely the hypothetical situation supposed at the beginning of this article was actually presented in the state of New York in 1919. In that year the state first enacted a personal income tax law,¹ which provided:

"A taxpayer receiving salary, wages, or other compensation from the United States as an official thereof, exempt from taxation under this article, shall be entitled to only so much of the personal exemption provided in this section as is in excess of the aggregate amount of such salaries, wages, or other compensation."²

It will be noted that this involves precisely our problem, except that the reduction of the personal exemption did not apply to interest on United States bonds. Unfortunately, perhaps, the validity of this law was never tested, as it was repealed the next year, and the repeal was given a retro-active effect. It is possible that doubts had arisen as to the constitutionality of the law but the reason given for its repeal was quite apart from legal considerations; it was simply that such niggardliness toward returning soldiers, who would be directly affected by this provision, was generally regarded as unworthy of the state. But there are a number of decisions bearing so closely on this problem as to indicate quite clearly the attitude of the courts toward it.

Authorities on the General Phases of the Problem

Not much help is to be expected toward the solution of this problem from the interstate commerce cases. Whatever may be the theory of the federal courts with regard to this matter, the fact is that considerable regulation by the states is acquiesced in, so long as no discrimination against such commerce is practiced. Indeed certain measures which seem somewhat discriminatory in effect (though clearly not in intention) have been sustained by the Supreme Court.³ But when it comes to an actual interference with the functions of the federal government by the states (or an interference with state functions by the United States) the rule is much more strict and is explicitly recognized by the Supreme Court to be so.⁴ Here no substantial burden will be tolerated.

¹ N. Y. Laws 1919, c. 627.

² Sec. 362, subd. 3 of the Tax Law, as amended by this statute.

³ *Reyman Brewing Co. v. Brister*, 179 U. S. 445, 21 Sup. Ct. 201 (1900); *Armour & Co. v. Virginia*, 246 U. S. 1, 38 Sup. Ct. 267 (1918).

⁴ *Gillespie v. Oklahoma*, 257 U. S. 501, 505, 42 Sup. Ct. 171, 172 (1922).

There is nothing in the federal constitution which explicitly forbids such interference by one government with the other; but the Supreme Court very early and, it seems, correctly found such restrictions implicit in our dual form of government.⁵ The restriction extends to the public agencies of the respective governments.⁶ And, at least with respect to official salaries, a tax by the other government will not be permitted to operate even though it is wholly without discrimination.⁷ In fact there has been, especially in recent years, a tendency to invalidate all state taxes which in any way affect income from the federal government, including interest on bonds of the United States or its agencies.⁸ This tendency reached its culmination in the recent case of *Macallen Co. v. Massachusetts*,⁹ where it was held that a state may not impose a franchise tax upon a domestic corporation where the tax is to be measured by the net income of the corporation without permitting the exclusion from such income of interest from United States bonds owned by the corporation. The court thus seemed to insist upon a discrimination in favor of the federal government as to the taxability of income derived from it, since the state law there invalidated was in no sense discriminatory against the federal bonds.¹⁰ If this is so, we should expect a like result in the problem of this article.

The present status of the *Macallen* case is, however, not altogether clear. The uncertainty arises from the fact that the reasoning of the court was largely buttressed upon the alleged dishonesty or at least artfulness of the state legislature in changing its tax statute so as to include these federal bonds, which were previously exempt. Of course this really means nothing, unless that some other state which had not previously exempted interest from United States bonds might impose the kind of tax which was here for-

⁵ *M'Culloch v. Maryland*, 4 Wheat. 316 (U. S. 1819); *Osborn v. United States Bank*, 9 Wheat. 738 (U. S. 1824).

⁶ *Farmers' etc. Sav. Bank v. Minnesota*, 232 U. S. 516, 34 Sup. Ct. 354 (1914); *United States Grain Corp. v. Phillips*, 261 U. S. 106, 43 Sup. Ct. 283 (1923).

⁷ *Dobbins v. Erie County*, 16 Pet. 435 (U. S. 1842); *Collector v. Day*, 11 Wall. 113 (U. S. 1870). See also *Evans v. Gore*, 253 U. S. 245, 40 Sup. Ct. 550 (1920) for an example in another field of constitutional law of the tendency of the Supreme Court to give little weight in taxation matters to mere freedom from discrimination.

⁸ *Indian Oil Co. v. Oklahoma*, 240 U. S. 522, 36 Sup. Ct. 453 (1916), holding that a corporate lessee of Indian lands cannot be taxed by a state either by a direct property tax or by a tax on the value of its stock, without in either case deducting the value of the leases; *Northwestern Mutual Life Ins. Co. v. Wisconsin*, 275 U. S. 136, 48 Sup. Ct. 55 (1927), holding that a state may not impose a tax on the gross income of domestic corporations without excluding from such income the interest on United States bonds held by the corporation.

⁹ 279 U. S. 620, 49 Sup. Ct. 432 (1929). See on this general subject, Brown, *Restrictions on State Taxation Because of Interference with Federal Functions* (1930) 17 VA. L. REV. 325.

¹⁰ It would seem also that the federal government must be likewise limited with respect to the taxation of corporations which hold state bonds; and that the case of *Flint v. Stone Tracy Co.*, 220 U. S. 107, 31 Sup. Ct. 342 (1911), which holds that such securities may be included in the measure of the federal tax even though they are not taxable directly, must be deemed to be overruled on this point.

bidden to Massachusetts. Such an idea, which would result in the states having different powers of taxation, is palpably absurd, and one must conclude that this argument in the *Macallen* opinion was mere window-dressing. Even so, it was made use of by the Tennessee Supreme Court to sustain a tax of that state which was similar in effect to the Massachusetts tax which the Federal Supreme Court had invalidated.¹¹ More important still, the Federal Supreme Court itself made further use of this curious idea for the purpose of distinguishing the *Macallen* case from the situation in *Educational Films Corporation v. Ward*.¹² This latter case upheld a New York corporate income tax as applied to a corporation receiving a large part of its income from copyrights—a decision logically inconsistent with the *Macallen* case, unless that case is to be based upon this alleged unethical performance of the Massachusetts legislature. The real truth is that the Supreme Court has made a strategic retreat from the undefendable position which it took in the *Macallen* case; and at the moment it is not quite clear how far the court will go.

But it may be surmised that it will not retreat very far. There is nothing, even in the *Ward* case, which would lead to the inference that the court means to open the door very wide to the affecting by taxation of United States functions and activities by the states, or *vice versa*. If any such effect is permitted, it will be limited to very indirect and inconsequential matters. Not only will any discrimination against the other member of our dual governmental system be forbidden, but it is clear that the court means to confine all effect of the taxation of one on the functions of the other within very narrow limits. All this indicates, so far as it goes, that the state tax statute assumed at the beginning of this article, and all others having provisions of similar effect, as well as federal laws dealing in like manner with income from the states or securities issued by them, will be condemned by the Supreme Court as contrary to the implicit requirements of our dual form of government.

State Court Decisions on the Precise Point

It is now appropriate to consider cases bearing more precisely on the point with which this article deals. Such cases are apparently not numerous, but they are by no means unknown. It is apparent that New York has not been alone among the states in trying some scheme of this sort, nor, as will presently appear, has the federal government refrained from making a like effort. But we may first consider the state cases.

¹¹ *General Securities Co. v. Williams*, 161 Tenn. 50, 29 S. W. (2d) 662 (1930). The court relies very largely on *Flint v. Stone Tracy Co.*, *supra* note 10, which it states quite correctly has never been explicitly overruled.

¹² 282 U. S. 379, 51 Sup. Ct. 170 (1931).

The general point of view of the state courts is that federal securities or income cannot be included as a basis of state taxation either directly or indirectly.¹³ They must be wholly excluded from consideration before the work of computing the tax begins. It would follow that any attempt to again bring in the federal securities or the receipt of income from the federal government in order to reduce the personal allowances or the deductions otherwise granted would be regarded as an unconstitutional burden on that government.

The first case found, directly in point on this matter, is *People v. Commissioners*,¹⁴ where it was held improper to add federal bonds to gross assets from which debts were to be deducted, in accordance with the state tax statute, for computing net taxable assets. It will be noted that this is rather a crude scheme, and so it is hardly surprising that it was defeated; the burden upon the federal securities is and appears quite direct. The importance of this case is also lessened by the fact that, while it seems to have been fully argued by both sides, it was decided from the bench without opinion.

More recent and more important is the Missouri case of *State ex rel. American Automobile Ins. Co. v. Schramm*,¹⁵ the facts of which are not very dissimilar to those of the New York case just discussed. Here the state law, in imposing a tax upon insurance companies based upon their net assets, permitted the deduction from gross assets of their liabilities and also their reserves. The taxing authorities tried to compel the taxpayer corporation to add to its gross assets, before the deduction was made, the amount of United States bonds held by it. The argument by which this action of the taxing authorities was attempted to be sustained was that the reserves were an exemption, which the state was not obliged to give, and if it did, it might do so under the condition of requiring the addition of the non-taxable assets of the company, so long as such assets did not exceed the deduction. The court conceded that the state was not obliged to permit the deduction of the reserves, but held that at any rate the attempt to add in the United States bonds could not be permitted, as this would result in the taxation of these bonds. This means, of course, that the tax authorities were required to discriminate in favor of taxpayers holding United States securities.

Probably the most important of the state cases is *Waco v. Amicable Ins. Co.*,¹⁶ a Texas decision. Here the scheme of the tax authorities was very little different in substance from those previously considered. There was a tax on the net personal assets of insurance companies, such net assets to be

¹³ See *In re Opinion of Justices*, 77 N. H. 611, 93 Atl. 311 (1915).

¹⁴ 41 How. Pr. 459 (N. Y. 1870).

¹⁵ 271 Mo. 223, 196 S. W. 21 (1917).

¹⁶ 230 S. W. 698 (1921), *aff'd*, 248 S. W. 332 (1923).

computed by deducting from gross assets not only the real estate (which was otherwise taxed) but the reserves. The taxing authorities contended that federal bonds, which were concededly tax-exempt, should nevertheless be added to the gross assets, on the theory that the reserve, which was to be deducted anyway, should be presumed to be invested in the non-taxable securities. But the court denied this contention, holding that the reserve is a statutory deduction irrespective of its investment, and that adding the United States securities to the gross assets resulted in the taxation of such securities, which is of course unconstitutional. The upper court pointed out that the legislature might, if it chose, limit the deduction of the reserve to certain classes of assets, so that it might result in certain taxpayers not getting the full benefit of this deduction; but the court insisted that no expedient by which the bonds were taken into account in computing the tax, could be permitted.

Finally we have the Michigan case of *Packard Motor Car Co. v. Detroit*.¹⁷ Here the statutory scheme was more ingenious, but not so much so as to escape a similar judicial condemnation. The statute provided for a property tax based on net assets. Such net assets were to be computed by deducting debts from gross assets; but it was provided that this deduction should be limited in the case of any taxpayer holding non-taxable assets, to the proportion of debts which the taxable assets bore to the total assets. The result would be that a taxpayer who owned United States bonds would not, of course, be taxable directly upon them; but he would not be permitted to deduct the whole of his debts. His neighbor who owned no such bonds would, of course, have no non-taxable assets, but, on the other hand, he could deduct all his debts. This, the court held, resulted in discrimination against the holders of government bonds, and thus an indirect burden upon the federal borrowing power, which was beyond the authority of the state.

Thus far, all the state authorities seem to be on the side of condemning the method of taxation, the validity of which is here being examined. There is one case which might, argumentatively at least, be claimed to be on the other side. The reference is to *Lumbermen's Indemnity Exchange v. State*,¹⁸ a decision of the Supreme Court of Washington. Here the state taxed the premiums of insurance companies at the rate of $2\frac{1}{4}$ per cent., but with a provision for a reduction of the rate to 1 per cent. to the extent that the premiums were invested in "bonds of the state". The problem before the court in this case was not the validity of the statute, but rather the more specific question whether "bonds of the state" included United States Liberty Bonds. It is hardly surprising that the court found that Liberty Bonds are not bonds of the state; the only cause for astonishment is that the taxpayer had the temerity to advance the ridiculous argument that they were. But

¹⁷ 232 Mich. 245, 205 N. W. 106 (1925).

¹⁸ 113 Wash. 82, 193 Pac. 217 (1920).

the taxpayer might have made a much more reasonable argument by contending that such a scheme operated as a burden upon the Liberty and other United States bonds, and was invalid on this account. The point not having been argued, the case is not much of an authority for it, but undoubtedly the court in construing the act inferentially sustained its validity.¹⁹

It is submitted, however, that this case is not really an authority against the position taken in the other state cases already summarized. It is true that these cases demonstrate that the mere fact that the federal securities are not directly taxed by the state is not necessarily sufficient to save the validity of the state scheme of taxation. It must also be conceded that they indicate that where a taxpayer does not substantially benefit with respect to the state tax by reason of his ownership of federal securities, that very circumstance is an indication of the invalidity of the state tax; and here the taxpayer certainly did not benefit by his ownership of the Liberty Bonds. But the discrimination, if there was one, was not against United States bonds as such, but against all bonds except those of the State of Washington. It would seem entirely proper, no matter what view one takes of the major problem under consideration here, that a state should be entitled to prefer its own bonds with respect to its taxation, so as to make them more attractive investments to its citizens. Yet indubitably the case is close, and those who feel that a state should not be compelled to ignore the existence of federal bonds for taxation purposes (though all would of course agree that no direct tax can be laid upon them) would be entitled to cite this case as an authority, although not a very strong one, in favor of their view.

It is apparent, however, that the prevailing view of the state courts is that a state may not reduce the deductions or personal exemptions generally accorded to taxpayers, by reason of the ownership by these taxpayers of securities of the United States. No cases have apparently arisen in these courts with respect to income from the United States, but it is clear that the answer of the state courts would be the same. And it is hardly doubtful that a similar attempted encroachment by the federal government upon state functions would also be regarded as invalid by these state courts. So we may now turn to a consideration of the decisions of the federal courts with respect to this problem.

The Federal Decisions

There is a curious chronological similarity between the decisions of this problem in the state and in the federal courts. In each there was a decision by a lower court in the 70's, and then the matter was seemingly dropped from judicial consideration until well along in the present century. One may

¹⁹ The case is also weakened by the fact that the court found the Liberty Bonds to be substantially equivalent to cash assets, so that they formed part of the cash reserves, which are not subject to tax.

hazard the guess that no very serious attempt to work this scheme was made by either states or nation until the World War and allied conditions multiplied the calls upon public revenue. At any rate, the matter is now of practical as well as of theoretical interest.

The one early case in the federal courts was *United States v. Ritchie*,²⁰ a decision of the District Court for the District of Maryland, in 1872. Here an attempt was made by persons connected with the administration of the federal income tax which was then levied, to apply the salary of a state's attorney against the statutory exemption—thus leaving a larger part of his other income to be taxed. The case thus presents a very simple example of our main problem. But the court in a very brief opinion refused to allow this scheme, "because that would, indirectly, make his income from such source liable to the taxation from which it is exempt". Thus the result was the same as in the state courts—the reduction of the exemption by reason of the ownership of tax-exempt securities is disallowed.

When, more than half a century later, the matter again came before the federal courts and was this time carried up to the Supreme Court, the result was the same. The first case was *Miller v. Milwaukee*,²¹ which involved a state income tax. It was provided in the statute that all income from United States bonds was to be deducted from gross income. But it was further prescribed that where the taxpayer was a corporation, the stockholders should be exempt from personal taxation on dividends received, only in the proportion that the corporation was taxable on its total income. To illustrate, if the corporation, by reason of its ownership of United States bonds, was exempt from taxation on one-half of its income, its stockholders would have to pay a tax upon one-half of the dividends received by them; whereas if all the income of the corporation was taxable, the dividends in the hands of the stockholders were fully exempt. This was a particularly clever scheme, because of the settled doctrine of the Supreme Court (a doctrine which seems to be unaffected by even such extreme cases as *Macallen Co. v. Massachusetts*²²) that in taxing stockholders of a corporation on their stock or the income from it, neither the state nor the national government need make allowance for the fact that the corporation is the owner of securities issued by the other government, so that such securities or the income therefrom could not be taxed directly.²³ The corporation itself is exempt (this exemption was recognized by the state law under consideration in this case) but

²⁰ Fed. Cas. No. 16168 (D. Md. 1872).

²¹ 272 U. S. 713, 47 Sup. Ct. 280 (1927).

²² *Supra* note 9.

²³ *Home Savings Bank v. Des Moines*, 205 U. S. 503, 27 Sup. Ct. 571 (1907). In certain unusual cases there may even be a slight discrimination against holders of stock of corporations that own United States securities. *Des Moines Bank v. Fairweather*, 263 U. S. 103, 44 Sup. Ct. 23, (1923).

the stockholder may be taxed without regard to the nature of the corporate assets.

Nevertheless, the state tax was invalidated by the Supreme Court.²⁴ This would seem to be a strong, and in fact well-nigh conclusive, authority against the validity of the entire scheme under consideration in this article, were it not for the fact that the reasoning of the court is on an entirely different basis. The opinion, written by Mr. Justice Holmes, does, to be sure, mention the apparent discrimination as respects the ownership of United States bonds, but the principal reason given for invalidating the tax is not that the state did in fact discriminate against such bonds, but that it intended to. For instance, it is said:

"If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good."²⁵

As was said in connection with similar reasoning of the court in *Macallen Co. v. Massachusetts*, this does not seem very convincing. It amounts to saying that a state tax should be condemned because it is intended to burden United States bonds even though it in fact fails to do so. Such a test would require the court to make a psychological and ethical test of all the members of the state legislature, and perhaps also of the tax officials. As this does not seem very practical, even if otherwise desirable, it must be concluded that *Miller v. Milwaukee* is a real authority for the proposition that such a state tax is unconstitutional because in fact, and not merely in intention, it is a burden upon the functions of the federal government.

It was only a year before the court was again called upon to pass upon such an arrangement; but this time the national government was the alleged offender. The case now referred to, *National Life Ins. Co. v. United States*,²⁶ is probably the most important decision which has yet been made with respect to this subject.

The case involves the validity of that part of the federal Revenue Act of 1921²⁷ imposing a tax upon insurance companies. The scheme was to compute the taxable net income by deducting from the gross income (1) the amount of interest received on tax-exempt securities, and (2) the amount, if any, by which 4 per cent. of the reserves exceeds the first deduction. The

²⁴ The court was unanimous in invalidating the tax, but Justices Brandeis and Stone concurred solely on the ground of a stipulation in the record that the tax was levied upon that portion of the dividends which were directly declared from interest on the United States securities. These justices did not concur in the reasoning of the court, and so may be regarded for our purposes as dissenting.

²⁵ *Supra* note 21, at 715, 47 Sup. Ct. at 280.

²⁶ 277 U. S. 508, 48 Sup. Ct. 591 (1928).

²⁷ 43 STAT. 288, §§ 242 to 247 inc. (1924), 26 U. S. C. A. §§ 1002 to 1007 inc. (1928).

effect of these provisions is well stated by Mr. Justice Brandeis (dissenting) as follows:

"Taken together, they provide for the deduction from the gross investment income of the interest from tax-exempt bonds or of an amount equal to 4 per cent. of the mean insurance reserve, whichever sum is the greater."²⁸

The plaintiff was a comparatively small company, but it owned certain amounts of state and federal²⁹ securities, which were not taxable. Its contention was that the statute was unconstitutional in that the non-taxable securities were in fact taxed. It asserted that it was entitled to have the benefit of the sum of these two exemptions—that is to say that it could properly deduct from its gross income both the exempt income and the 4 per cent. of its reserves. This argument was buttressed by a mathematical demonstration that under the statute it received not one penny of benefit as to taxes by reason of its ownership of the non-taxable securities. It seems clear that the statute was so drawn as to make this result inevitable in every case. So the question is squarely presented.

Before discussing the decision of the court, one other matter should be mentioned. This part of the Revenue Act of 1921 was drafted in consultation with most of the important insurance companies, and the arrangement was as satisfactory to them as to the government. In fact, several of the largest companies employed Mr. Charles Evans Hughes (now the Chief Justice of the Supreme Court) to present a brief in their behalf as *amici curiae* in support of the tax.

But the government, notwithstanding its weighty and rather unusual support from the taxpayers, was unsuccessful. The provisions with respect to deductions, which have been summarized, were held unconstitutional in so far as they restricted the deduction to the larger of the two items. The plaintiff therefore succeeded in its endeavor—an endeavor which seems to have been as unpopular with most of its competitors as with the government itself—to subtract, not the difference between the two items, but their total. There were, however, three dissenters in the court—Justices Brandeis, Stone, and Holmes.

Mr. Justice McReynolds delivered the opinion of the court. He mentions the theory which was apparently governing in *Miller v. Milwaukee*,³⁰ that the act evidences an improper intent of the legislative body—in this instance Congress—to indirectly burden the state and other non-taxable securities, which it knew it could not tax directly. But not much is made of

²⁸ *Supra* note 26, at 524, 48 Sup. Ct. at 594.

²⁹ The federal securities were issued as tax-exempt, and were considered by the court as falling within the same rule as the state securities.

³⁰ *Supra* note 21.

this. In view of subsequent cases³¹ one would not gather that this was because the court was willing to admit any loss of faith in the theory; perhaps it was because any attempt to rely on it would be rather absurd under the facts of this particular case, where most of the taxpayers concerned, themselves cooperated in the formulation of the scheme and sought to sustain it. Under such circumstances a claim of artful and dishonest action by Congress would hardly do.

The court did in fact come to grips with the real problem in this matter—this must be admitted whether or not one agrees with its solution. The crux of the opinion comes in the following language:

“Because of the receipt of interest from such securities, and to its full extent, pursuing the plan of the statute, the Collector diminished the 4 per cent. deduction allowable to those holding no such securities. Thus, he required petitioner to pay more upon its taxable income than could have been demanded had this been derived solely from taxable securities. If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted.”³²

One comment only need at present be made with respect to this language. The plaintiff did not pay more taxes because of its ownership of non-taxable securities; its complaint is that it is, according to the statutory scheme, not permitted to pay less. It is true that the plaintiff did pay more on its taxable property as such, but this point is a mere technicality unless it follows therefrom that there is a discrimination against the non-taxable securities and so against the issuing governments.

But it is now time to consider the dissenting opinions of which there are two, one by Mr. Justice Brandeis and the other by Mr. Justice Stone. These two justices assume to agree with each other, and Mr. Justice Holmes, the other dissenter, is recorded as agreeing with both. But in fact the two dissenting opinions are not wholly consistent, since Mr. Justice Brandeis strenuously denies that there is any discrimination against the plaintiff as the holder of state securities, whereas Mr. Justice Stone concedes that there is.

Mr. Justice Brandeis' opinion is largely concerned with the idea that the plaintiff is not entitled to any better treatment because of its ownership of tax-exempt securities; it is sufficient if it is treated no worse because of this circumstance. Thus he says:

“It may be assumed—if the term is used with legal accuracy—that the United States may not discriminate against state bonds or against its own outstanding bonds. Discrimination is the act of treating differently

³¹ Especially *Educational Films Corp v. Ward*, *supra* note 12.

³² *Supra* note 26, at 519, 48 Sup. Ct. at 593.

two persons or things, under like circumstances. . . . Here the sole complaint is that the two, although the circumstances are unlike, are treated equally. The claim is not that the holder of tax-exempt bonds is denied a privilege enjoyed by others. It is that the holder of tax-exempt bonds should be given in respect to another matter a preferred status. . . . The Constitution does not require the United States to hold out special inducements to invest in state bonds.”³³

Both dissenting opinions emphasize the fact that the deduction of a percentage of the reserves was a concession to the companies, which the government was not required to make. Of course this fits in perfectly with Mr. Justice Brandeis’ argument that there is really no discrimination; that all that was denied to the plaintiff was a bonus, to which it was not entitled anyway. Mr. Justice Stone obviously cannot make much of this after his explicit admission “that the petitioner has been discriminated against”; though he tries to persuade himself that a discrimination with respect to a bounty is no discrimination. But the real point of his opinion is in the following sentence:

“But even though the result now reached were to be deemed a logical implication of the doctrine . . . , that neither national nor state governments may tax the instrumentalities of the other, still, as this Court has often held, that rule may not be pressed to the logical extreme of forbidding legislation which affects only remotely or indirectly the holders of the other’s securities.”³⁴

This is obviously a new idea and one which may prove helpful in this problem. But there can be little doubt that *National Life Ins. Co. v. United States* is a strong authority that the reduction of tax exemptions of any nature by reason of the ownership by the taxpayer of tax-exempt securities or the receipt by him of any tax-exempt income, is unconstitutional because imposing a burden upon such securities or income.

The next case on this point is *Missouri ex rel. Missouri Ins. Co. v. Gehner*.³⁵ Here a state tax upon the net assets of insurance companies was in issue. The gross assets were to be reduced by United States bonds and also by the legal reserve and unpaid policy claims, in order to compute the taxable net assets; but it was decided that the deduction for the reserve and the policy claims should be allowed only in the proportion which the taxable assets bore to the total assets.³⁶ The result was that the relator, which was the holder of United States securities, was not permitted to deduct the whole of its

³³ *Ibid.* 530, 48 Sup. Ct. at 597.

³⁴ *Ibid.* 536, 48 Sup. Ct. at 599.

³⁵ 281 U. S. 313, 50 Sup. Ct. 326 (1930).

³⁶ This does not seem to have been provided, explicitly at least, in the statute; but the tax authorities construed the law in this manner. This construction was in substance upheld by the state courts.

reserves and policy claims, as it could have done if it had not held such non-taxable securities; the deduction was reduced in the exact proportion of the United States securities held by the taxpayer.

The court held that such a tax was invalid as "an infringement of the guaranteed freedom from taxation". The opinion by Mr. Justice Butler is concerned mainly with the rather involved procedure of the state administrative bodies and courts in the case; this being necessary because of a claim by the defendant that the question was not properly before the court. Having decided that it was, no difficulty seems to have been experienced in reaching the conclusion that the tax was invalid. The very brief argument on this point is mainly based upon *National Life Ins. Co. v. United States*.³⁷ In fact Chief Justice Hughes announced his concurrence solely upon the ground that the case was governed by the *National Life Ins. Co.* case, in which, it will be remembered, he had been an unsuccessful advocate in favor of the validity of the tax.³⁸

A dissenting opinion was written by Mr. Justice Stone, and was concurred in by Justices Holmes and Brandeis. Most of this opinion concerns itself with a restatement of the arguments against the whole doctrine of the majority, and these have already been sufficiently summarized. But an attempt is made to distinguish this case from the *National Life Ins. Co.* case. Without considering the argument in detail, it may be said that it is doomed to failure; the position of the Chief Justice is clearly correct. If it is unconstitutional to reduce exemptions by the full amount of tax-exempt securities held by the taxpayer, because this means a burden upon such securities, the partial reduction of the exemption by reason of the same ownership of tax-exempt securities is just as surely a burden—though perhaps one of less weight—on the tax-exempt securities. The *Gehner* case, then, rests upon the *National Life Ins. Co.* case, and, while important, is nevertheless little more than a cumulative authority upon our problem.

If this were all, there could be little doubt of the answer to our main problem so far as authority is concerned, however it may be on principle. Reductions of tax exemptions by reason of the ownership of tax-exempt securities or the receipt of other tax-exempt income, would certainly be invalid. But this is not all. During the last session of the Supreme Court, there were two decisions which seem to throw much doubt on this solution of our problem—a solution which seems hitherto to have regularly been accepted by all the courts.

Of these recent cases, the first and much the most important is *Denman v. Slayton*.³⁹ This case involved the validity of the section of the Revenue

³⁷ *Supra* note 26.

³⁸ See p. 543 *supra*.

³⁹ 282 U. S. 514, 51 Sup. Ct. 269 (1931).

Act of 1921⁴⁰ (there is a similar provision in the present act) relating to the deduction of interest from gross income in order to compute the net taxable income. It was provided that all such interest on indebtedness paid during the year by the taxpayer might be deducted "except on indebtedness incurred or continued to purchase or carry obligations or securities . . . the interest upon which is wholly exempt from taxation under this title". The result is that interest on state obligations is exempt from federal income tax; but if indebtedness is incurred to purchase or carry such a security, the interest upon such indebtedness is not deductible, though all other interest is.

Both of the lower courts from which the case was appealed, held this limitation on the deductibility of interest invalid, under the doctrine of *National Life Ins. Co. v. United States*.⁴¹ It is submitted that these lower courts were correct, if the doctrine is to be applied literally as laid down in the majority opinion in that case. It is true that the deduction does not vary directly or even proportionally with the amount of non-taxable securities owned, since they may be purchased for cash rather than on credit. But this distinction seems to be unimportant, since if the state securities are bought for cash there is no interest to deduct. The truth seems to be that here also the taxpayer is denied a deduction of interest which he actually pays, solely by reason of his ownership of non-taxable securities. It may be conceded that the provision of the Revenue Act under consideration is entirely reasonable, but this does not seem to save it under the language of the *National Life Ins. Co.* opinion, which has been quoted above.⁴² The burden upon the state securities may be reasonable, but it exists just the same.

Nevertheless, a unanimous court, speaking again by Mr. Justice McReynolds, reversed the lower courts and sustained the tax. The main argument of the opinion appears in the following excerpt:

"The circumstances disclosed in *National Life Ins. Co. v. United States* were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of sec. 245 (a), Revenue Act of 1921. . . . While guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the payment of their just share of a burden fairly imposed."⁴³

As already shown, this attempt to distinguish the *National Life Ins. Co.* case seems to be technically sustainable but not very substantially satisfying.

⁴⁰ 42 STAT. 227, § 214 (a) (2) (1921).

⁴¹ *Supra* note 26.

⁴² See p. 544.

⁴³ *Supra* note 39, at 519, 51 Sup. Ct. at 270.

To tell a taxpayer that he is not at all deprived of benefit from his ownership of tax-exempt securities by depriving him of the deduction of interest paid on indebtedness connected therewith, because he might have bought the securities for cash, is not very satisfactory, in view of the fact that in the latter case he would not have any interest to deduct, anyway. It would seem, and indeed the last sentence in the above quotation is almost an avowal, that the court is tending toward the view that our problem is to be decided not technically, but reasonably according to the circumstances. This, it will be remembered, is the view of Mr. Justice Stone in his dissenting opinion in the *National Life Ins. Co.* case.⁴⁴

Not directly in point, but still having a certain bearing upon this problem, is *Storaasli v. Minnesota*,⁴⁵ which however does not involve intergovernmental relations. The case involves the application of a state excise tax⁴⁶ upon the use of automobiles on the roads of the state, to the case of a non-resident army officer stationed at a military reservation within the boundaries of the state. The only contention in behalf of the taxpayer which is of interest to us, was based upon a provision of the law exempting from the tax for a long enough period to cover his own situation, all persons whose cars were registered outside the state. Since this particular taxpayer was in the unfortunate position of a non-resident who had not registered his car in another state, he claimed that the tax was unduly discriminatory as to him. But the court declined to give him any relief, saying:

"The mere fact that appellant has not so registered his car and cannot, therefore, bring himself within the class benefited by the exemption, does not create a discrimination against him."⁴⁷

Thus, while this case is not really an authority on the point, it indicates an increasing disinclination by the court to invalidate tax laws merely because the taxpayer is unable to take advantage of the same exemptions from which others not very dissimilarly situated, benefit.

For all that, *Denham v. Slayton*⁴⁸ is the only case that can fairly be cited as a direct authority in favor of the validity of the scheme here under consideration. Practically all the others are quite as squarely against it. It remains to consider the problem on principle—assuming there is such a thing—and to inquire whether by this, or any other method, the authorities can be reconciled.

⁴⁴ See quotation from that opinion on p. 545 *supra*.

⁴⁵ 283 U. S. 57, 51 Sup. Ct. 354 (1931).

⁴⁶ The statute did not make entirely clear the precise nature of the tax; but the court construed it in this way.

⁴⁷ *Supra* note 45, at 63, 51 Sup. Ct. at 356.

⁴⁸ *Supra* note 39.

Conclusion

We may well, at this point, return to a consideration of the hypothetical case with which we started.⁴⁹ If in that case *A* is improperly taxed it is because his failure to benefit from his receipt of non-taxable income is a discrimination against him for the very reason that he receives such non-taxable income. If this is so, it means that in order to avoid discriminating against persons who own non-taxable securities or receive non-taxable income, the tax law must discriminate in their favor.

This sounds like a paradox, but on examination is not as absurd as it looks. We must now consider *B*, who, it will be remembered, has the same income as *A* and pays exactly the same tax. Yet all of *B*'s income is taxable. Now if the federal government is to obtain any benefit from the exemption to which *A* is entitled, it must be through a benefit to *A* by a reduction in his tax liability. Such a benefit may be assumed to be a factor in inducing *A* to accept a lower salary than would be the case if it were fully taxable.⁵⁰ But the benefit to *A* and through him to the federal government can be obtained only if the state is compelled to discriminate in favor of *A* by reason of the fact that he is a United States employee.

To this argument, the only answer which has been found in the dissenting opinions of the cases stated above which invalidate this scheme, is that the exemptions or deductions are purely optional with the taxing jurisdictions, and so may be granted on the condition that they be reduced by reason of the fact that part of the income is non-taxable. But it is submitted that this argument is unsound. It is true that exemptions are not compulsory so far as the subject is within the jurisdiction to tax; but an exemption given to one taxpayer must be given to all unless the classification is not merely reasonable but does not result in the inclusion of the subject of the tax, something which is not within the jurisdiction. That is the difficulty here. To consider again our hypothetical case, the only distinction between *B*, who has the benefit of the entire personal exemption, and *A*, who does not, is that *A* has income which the state has no right to tax. The state must either give *A* the same deduction which it gives *B* or else justify the distinction; and it can hardly do so by showing that *A* differs from *B* in that he receives income which is outside of the state's jurisdiction to tax. This is certainly discrimination against *A* and so indirectly against the federal government.

Mr. Justice Brandeis has made the additional argument that discrimination exists only when there is a difference of treatment under like circumstances—not as here, when there is like treatment under different circumstance.⁵¹

⁴⁹ See p. 534 *supra*.

⁵⁰ No doubt the efficacy of this consideration in substantially reducing government salaries or interest charges is somewhat questionable; but it is the only sensible reason for insisting upon reciprocal exemptions in intergovernmental relations, at all.

⁵¹ See quotation from his dissenting opinion in *National Life Ins. Co. v. United States*, on p. 544 *supra*.

Really this is only a restatement of the argument in favor of the validity of this method of taxation already stated and answered. But it may be helpful to put an additional hypothetical case to see how this theory would work out. *M* has \$2000 income, one-half of which is tax-exempt. An income tax of \$1000 is imposed. *N*, on the other hand, has \$1,000,000 income, all of which is taxable. He also is taxed \$1000. According to Mr. Justice Brandeis there is no discrimination. Perhaps not; but if such is the case, the forbidding of discrimination in intergovernmental relations is about as useful as specifically enforcing a contract to enter into a partnership, in a jurisdiction which permits a partner to withdraw at any time. Discrimination is, or ought to be, a substantial and not a technical matter.

It hardly needs to be added that the foregoing argument applies to all phases of our subject; to a state tax which affects non-taxable property, especially United States securities, as well as one which affects salaries paid by the federal government; and to national taxes which affect state functions and securities as well as to state taxes interfering with the national government. The rule then would seem to be that the reduction of tax exemptions by reason of the ownership of tax-exempt securities or the receipt of non-taxable income is a discrimination against the other member of our dual governmental system. Such a scheme is, therefore, at least *prima facie* invalid.

But the argument which has already been made that discrimination should be tested on a practical rather than a technical basis suggests that there must be some limit to the application of this rule. Nothing could be more unworkable or unfortunate—in a word impractical—than to carry the theory to its logical conclusion. Where the line is to be drawn is well stated in the dissenting opinion of Mr. Justice Stone in the *National Life Ins. Co.* case, which has already been quoted.⁵² It is not meant to assert here that Mr. Justice Stone was right in that case and that the majority was wrong; all that is said is that his argument was valid and pertinent and that the majority opinion would have been strengthened if it had dealt with this aspect of the matter. Where the effect is remote and inconsequential, and especially where the burden laid on the securities or functions of the other government is no more than is reasonably necessary to prevent the unjustified evasion of the taxation, the statute should ordinarily be sustained. It cannot be too often repeated that our dual form of government, and especially this most delicate phase, the reciprocal immunity from taxation by state and nation of the functions of the other, can only be carried on by making reasonable adjustments to protect the spirit, even if the letter is sometimes not rigidly adhered to. To carry out the letter of the tax immu-

⁵² See p. 545 *supra*.

nity to its logical conclusion would, it seems, result in each government destroying, or at least having power to destroy, the other.

It remains to test the situations which have already arisen, by this standard. There seems to be little doubt as to the answer with respect to the hypothetical case stated at the beginning of this article, and also the New York income tax as originally enacted.⁵³ In such a case we have a very direct and quite heavy burden upon the functions of the federal government; and the only benefit to the state is the wholly unjustifiable one of being able to collect a tax from a source which is outside its jurisdiction. Such a method of taxation is clearly improper, and should be invalidated.

The same rule applies to the situations presented in all of the state court decisions summarized in this article where the tax was invalidated, except possibly *Packard Motor Car Co. v. Detroit*,⁵⁴ which will be considered later. In all of these cases the burden upon the federal securities was direct and of sufficient weight to discourage investment in them—or at least to largely take away any encouragement to do so which would otherwise exist. It seems therefore, that all these cases were correctly decided.

As for the federal cases, *United States v. Ritchie*⁵⁵ very clearly falls within the same general principle, and was correctly decided. The construction of the federal statute which was insisted on by the administrative authorities was a clear and direct burden upon the salary paid by the state.

*Miller v. Milwaukee*⁵⁶ raises a more difficult problem, but the opinion is hazarded that it too was correctly decided. The scheme of the state statute was ingenious, but it can hardly be denied that there was a discrimination against stockholders of corporations which were the holders of United States bonds. Such discrimination would, or at least might, appreciably discourage the investment by corporations in such bonds. And so the court seems justified in invalidating the statute, notwithstanding the unfortunate reasoning by which the result was reached. It must be admitted that this is rather a close case, but if, as is here contended, any such scheme is *prima facie* invalid, the court may properly presume in favor of such invalidity. The presumption in favor of constitutionality should not apply in this sort of case.

But there are cases where such a method of taxation should clearly be upheld. Such is *Denman v. Slayton*.⁵⁷ As already pointed out, the reasoning of the court is not very convincing, and it seems difficult to deny that the federal statute there being considered does slightly burden state securities by discouraging investment in them. But this burden is so light as to be fairly within the "*de minimis*" rule. The fact that the statute does not affect

⁵³ See p. 535 *supra*.

⁵⁴ *Supra* note 17.

⁵⁵ *Supra* note 20.

⁵⁶ *Supra* note 21.

⁵⁷ *Supra* note 39.

cash purchases, while immaterial so far as any particular taxpayer is concerned, does in fact reduce the burden upon the securities, which is the real point in issue. Furthermore—and this is the most important point—the prohibition of such a provision in the federal Revenue Act would distinctly injure the national government, by facilitating the evasion of its legitimate taxation, without any corresponding benefit to the states—in fact probably without any real practical benefit at all to them. Such being the case, the Supreme Court was not only justified, but it seems to have been clearly its duty to sustain the provision in issue.

The same argument applies *a fortiori* to *Lumbermen's Indemnity Exchange v. State*.⁵⁸ It may be questioned whether there was even any theoretical injury to the national borrowing power in that case; at any rate, the practical effect would probably be nil. On the other hand, the statutory provision there considered ought to be of substantial assistance to the state in borrowing money. Such a provision which is of practical assistance to the state and which imposes only a theoretical burden on the federal government (and with even the theoretical burden doubtful) should certainly be sustained.

This leaves for consideration only the federal cases of *National Life Ins. Co. v. United States*,⁵⁹ and *Missouri ex rel. Missouri Ins. Co. v. Gehner*,⁶⁰ and the state case of *Packard Motor Car Co. v. Detroit*.⁶¹ However, the *Gehner* and the *Packard* cases involve almost identical problems and so may be considered together. We now take up the *National Life Ins. Co.* case.

This is a rather difficult problem. It seems that there is a fairly direct burden upon the state securities; for one thing, as the court pointed out, the deduction, and so the basis on which the tax is computed, varies directly with the amount of state securities held by the taxpayer. On the other hand, this burden is very slight, and moreover the statutory scheme was not only approved but vigorously urged by the overwhelming majority of the taxpayers concerned. This does not precisely prove that there was no improper burden on the borrowing power of the states, but it does show that the potential investors in state securities who were interested in the tax, did not think there was. They did not seem to feel that such a federal tax would discourage their investment in state securities. This case also is close, but one is led to believe, by the circumstances already mentioned, that an opposite result, sustaining the tax on the reasoning of the dissenting opinion of Mr. Justice Stone, would probably have been more desirable.

⁵⁸ *Supra* note 18.

⁵⁹ *Supra* note 26.

⁶⁰ *Supra* note 35.

⁶¹ *Supra* note 17.

The *Gehner* and the *Packard* cases resemble the case last considered in that the taxable basis varied directly with the amount of non-taxable securities held; they differ in that the deduction was reduced and the taxable basis thus increased by only the proportion which non-taxable assets bore to taxable. This would seem to indicate that the tax burden on non-taxable assets was lighter and so the tax less objectionable than in the *National Life Ins. Co.* case. But this is not so clear when we reflect that the cases now under consideration involve property rather than income taxes. Here the burden is felt more promptly and with much greater effect. It is submitted, therefore, that the courts which decided these cases probably reached the correct result; that the burden upon the tax-exempt securities was sufficient to impede appreciably their issuance and circulation.

Our survey of the cases on this point which have been before the courts, thus indicates that nearly all have been correctly decided, though often the opinion of the court does not embody very commendable reasoning. In this period of financial strain and stress, which is felt by governments as well as by private interests, the problem which is under consideration here may perhaps be expected to be placed before the courts more frequently than in the past. If the foregoing discussion is sound, it follows that the correct solution depends on the application of the following principles:

The reduction of tax exemptions (including deductions granted in the computation of the tax basis) by reason of the ownership by the taxpayer of tax-exempt securities or the receipt by him of tax-exempt income is *prima facie* invalid. The invalidity depends upon the fact that such a tax method results in a burden upon the government issuing the securities or paying the income. The burden, in its turn, depends not upon an actual increase of the tax liability by reason of the ownership of the securities or receipt of the income, for there is no such increase, but rather upon the fact that the taxpayer receives no benefit in comparison with other taxpayers who own no such tax-exempt property nor receive non-taxable income. Thus, a discrimination in favor of recipients of tax-exempt income and owners of tax-exempt securities must be made in order that the governments paying such income or issuing such securities may receive any benefit from the reciprocal tax immunity, which is such an important feature of our dual form of government.⁶²

It follows that in case of doubt the courts should invalidate any such methods of taxation. But not all should be held unconstitutional; the invalidity is only *prima facie*. If the burden upon the tax-exempt securities or income is slight and inconsequential, and especially, as is not infrequently the case, if such burden is much less than that which the invalidation of

⁶² It is not denied that such reciprocal immunity might very possibly be given up without injury, and indeed with probable benefit, to the nation and the states; but so long as it is preserved it must, in order to be effective, be applied as herein set forth. Cf. *supra* note 50.

the scheme would impose upon the taxing government, because of the opportunity thereby accorded for the evasion of its legitimate taxation, the tax should be sustained, notwithstanding its theoretical invalidity.

As already said, the courts have generally reached results consistent with these principles, though without always apparently recognizing them. A conscious approach to the problem from this standpoint might result in somewhat greater liberality in sustaining this method of taxation; but no very great change in results would be expected. The whole scheme is necessarily contrary to the rigid hands-off policy which has been insisted on between nation and state, as inherent in our dual form of government; it should therefore be sustained only in rather exceptional circumstances.